82-1195

Supreme Court, U.S.
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No.

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1982

DALE F. MEYER,
on behalf of himself and
all others similarly situated,
Petitioner,

vs.

THOMSON & MCKINNON AUCHINCLOSS KOHLMEYER, INC.,
UCA SYSTEMS, INC., JAMES L. MILLER,
and GERALD P. KOOYERS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTION PRESENTED

Whether investment in a managed commodity futures trading program based on a proprietary computer selection formula and marketed to the general public through a brokerage firm may involve the sale of an investment contract, and therefore of a security, within the meaning of and subject to the registration requirements of the Securities Act of 1933.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Dale F. Meyer, on behalf of himself and all others similarly situated, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the District Court for the Northern District of California (App. A) was not published. The opinion of the court of appeals (App. B) is reported at 686 F.2d 818.

STATUTES INVOLVED

The relevant provisions of Sections 2 and 5 of the Securities Act of 1933 (15 U.S.C. §§ 77b(1) and 77e(c)) are set forth in the Appendix (App. E).

JURISDICTION

The judgment of the court of appeals was entered on September 9, 1982. (App. C). By order dated November 17, 1982, Mr. Justice Rehnquist extended the time within which petitioner could file a petition for writ of certiorari to and including January 14, 1983. (App. D).

STATEMENT OF THE CASE

This case was decided on undisputed facts:

Respondent Thomson McKinnon Securities, Inc., a Delaware corporation with its principal place of business in New York City, engages in business as a securities broker-dealer and commodities trader. Respondent James L. Miller was employed by Thomson McKinnon in its Palo Alto, California office as an account executive having direct contact with the public (R. 36, interrogatory # 3).[1]

Respondent UCA Systems, Inc. is a California corporation wholly owned by respondent Gerald P. Kooyers (R. 24, interrogatories # 1(a) and 3). UCA developed a systematic, computerized scheme for trading commodity futures.

Together, respondents publicly offered and sold investments in managed commodity futures trading accounts. Petitioner, a high school janitor making $600.00 per month, was persuaded by Thomson McKinnon, through Miller, to

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[1] "R." refers to the original record filed in the court of appeals.

invest some $40,000 in respondents' scheme whereby the funds would be deposited with Thomson McKinnon, who would execute the trades based on the computerized signals generated by UCA's selection formula. Pursuant to respondents' scheme, UCA would ". . . cause commodity contracts to be bought, sold, sold short, and spread, and will have exclusive authority to issue all other necessary instructions to the broker." (R. 59, deposition of Meyer, Vol. 2, Ex. 6, p. 12 ¶ 2.)

Thomson McKinnon was paid commissions on a per trade basis and earned $1,848 in commissions in less than three months (R. 24, Ex. A to UCA's answers, etc., to plaintiff's first set of interrogatories). UCA determined the trades in all accounts it was managing by use of the "Statistical Qualifier System" it had developed and was paid a fee of 6% of the managed assets every three months, or 24% per year (R. 59, deposition of Meyer, Vol. 2, Ex. 6, p. 12 ¶¶ 4, 8). All the accounts managed by UCA were traded uniformly based on these computerized signals. In each account, the investor remained passive.

Respondents describe their methodology as follows:

> The Statistical Qualifier System is a unique approach for the speculative trading of commodity futures. It is based on the premise that although commodity price movements tend to be largely random in nature, significant trends originate in these random action patterns, and can be identified as they emerge. Since, fundamentally, economic pressures are the motivating forces behind commodity price movements in the long run, a statistical discriminator is used to filter out the signals of random action, and identify significant price movements. [R. 59, deposition of Meyer, Vol. 2, Ex. 6, p. 6.]

REASONS FOR GRANTING THE PETITION

The decision below, holding that a managed commodity futures trading account is as a matter of law not a "security" under the Securities Act of 1933, squarely conflicts with *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974), and is not consistent with the conclusion of this Court in *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946). The definition of a security for purposes of federal securities law, in this and other contexts, has occasioned increasing conflict and confusion among the lower federal courts, and should be clarified by this Court in the interest of the proper and uniform application of the federal securities laws and the removal of unnecessary litigation from the federal courts. Such a clarification, drawing on the insights of modern finance theory, is clearly feasible, and will provide the badly needed guidance this important question warrants.

1. As formulated by this Court in *Howey*, the test of an investment contract is "whether the scheme involves an investment of money in a common enterprise with profits to come solely with the efforts of others" (328 U.S. at 301). Not surprisingly, every element of that definition has subsequently received close scrutiny and elaboration. The only element that the court below found lacking in the instant case was the existence of a common enterprise.

Two lines of approach to the definition of a common enterprise have evolved in the cases. Some courts have demanded that the scheme exhibit "horizontal commonality"—a pooling of the capital contributed by investors in the way the venture is operated, usually accompanied by a pro-rata sharing of the residual profits (if an equity in-

vestment) or promised return (if debt). See, e.g., *Wasnovic v. Chicago Board of Trade*, 352 F.Supp. 1066 (M.D.Pa. 1972), aff'd mem., 491 F.2d 752 (3d Cir. 1973), cert. denied, 416 U.S. 994 (1974); *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216 (6th Cir. 1980), aff'd on other grounds, ... U.S. ....., 102 S.Ct. 1825 (1982); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96 (7th Cir. 1977). The typical business corporation issuing common stock or debentures clearly meets a horizontal commonality test.

But other courts have held that, in the absence of such a pooling, the common enterprise requirement may be satisfied by something else: "vertical commonality", in the sense of some species of common venture between the investors and the promoter in which different investors may be differently affected. There is disagreement, however, over the nature of the relationship between promoter and investor which is needed. The Fifth Circuit looks to whether the outcomes for the individual investors, though they may vary in some respects and are not pro-rata equivalents, nonetheless have in common the fact that they are essentially determined by the promoter's expertise and efforts which are applied uniformly to all accounts. See *SEC v. Koscot Interplanetary*, 497 F.2d 473, 478 (5th Cir. 1974); *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974). The Ninth Circuit, on the other hand, requires that, to have a common enterprise, the promoter must share directly in the individual investors' profits and losses; it is not enough that the promoter's business and income will be affected generally by how well his investor clients do. See *Brodt v. Bache & Co., Inc.*, 595 F.2d 459 (9th Cir. 1978); *Mordaunt v. Incomco*, 686 F.2d 815 (9th Cir. 1982).

As applied to managed commodity futures trading accounts, these divergent views have led to their being held securities by the Fifth Circuit because "the success of the trading enterprise as a whole and customer investments individually is contingent upon the sagacious investment counseling of Continental Commodities" (497 F.2d at 522), and being held not to be securities by the Ninth Circuit because "Bache could reap large commissions for itself and be characterized as successful, while the individual accounts could be wiped out" (595 F.2d at 461).

Not only does the Ninth Circuit's view, as applied once more to sustain the dismissal of petitioner's complaint, conflict with the holding of the Fifth Circuit, it is also inconsistent with the basic *Howey* decision of this Court. In *Howey,* an orchard operator sold off title to individual groves of citrus trees to individual investors, offering at the same time a servicing contract to tend the groves and harvest and market the fruit; the arrangement was held to constitute an investment contract, and hence the sale of an unregistered security. The stipulated facts in *Howey,* set forth in the opinion of court of appeals below, make it clear that this Court's finding of a common enterprise was not predicated on the existence of what is now termed "horizontal" commonality, nor on "vertical" commonality by the Ninth Circuit's standard, but instead on a reading consistent with the Fifth Circuit's interpretation. *SEC v. W. J. Howey Co.,* 151 F.2d 714 (5th Cir. 1945).

To quote from the stipulated facts: "In the care of each grove, as in the yield of the fruit, the cost of the care and the proceeds of [the sale of] the fruit may be, and are, definitely and distinctly accounted for with respect to the specific property owned by the individual." (151 F.2d at

716 n.5). The point was further highlighted in the opinion text: "Here it is quite clear that each purchaser looked for the income from his investment to the fruitage of his own grove and not to the fruitage of the groves as a whole. It is quite clear, too, that each purchaser's income was in no sense dependent upon the purchase or development of other tracts than his own except in the sense that as grove owners generally prospered, each owner of a grove would." (151 F.2d at 717).

In *Howey*, it is evident, investors did not have an undivided or pooled interest in the residual profits of the entire orchard; horizontal commonality was lacking. Likewise, the promoter would derive income from servicing fees and marketing charges, regardless of whether the grove owner made a lot of money or none at all; vertical commonality by the Ninth Circuit's test was lacking. But this Court held that the overall management supplied by the promoter was necessary to the feasibility of the operation and sufficient (in conjunction with the other elements) to constitute a common enterprise.

In sum, the court of appeals' decision in this case is in conflict with the holdings of the Fifth Circuit and with the foundation for this Court's decision in *Howey*. Respondents have together publicly offered opportunities to invest in commodity trading accounts, uniformly managed in accordance with a unique and vaunted computer trading program; there was a common enterprise, in the *Howey* sense. This Court should resolve the conflict among the circuits, and dispel the confusion over the meaning of the common enterprise requirement, which goes to the heart of the most basic concept in the application of the federal securities laws.

2. Even more fundamentally, there is pressing need for a reconsideration and clarification of the "security" definition as a whole. Lower courts have exhibited substantial uncertainty and conflict over the proper scope of coverage of the federal securities laws, outside of the central core area of a business corporation issuing stock or debt to the investing public. Some examples follow.

To determine whether a loan by a bank or other institutional lender involves the purchase of a security (a promissory note) from the borrower within the purview of federal law and its anti-fraud sections, courts have concocted a whole array of tests. Some attempt to dischotomize the note cases into either commercial or investment transactions, with only the latter being defined as securities. See, e.g., *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973); *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), cert. denied, 423 U.S. 825 (1975). The Second Circuit came up with a short and rather ad hoc list of note transactions which it felt ought not to be covered, and suggested that the test in other transactions should be whether they bear a "strong family resemblance" to those on the list. *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976). The Ninth Circuit held that the ultimate inquiry is whether the lender/investor contributed "risk capital" subject to the borrower's managerial efforts, and enumerated at least six factors to be considered. *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

When a business is sold in the form of the sale of 100% of the common stock by a small group of old owners to a small group of new owners, the courts are divided over the applicability of the federal securities laws. The

Seventh Circuit has held that the transaction does not constitute the sale of "securities", *Canfield v. Rapp & Sons, Inc.*, 654 F.2d 459 (7th Cir. 1981), while the Second Circuit has held that it does, *Golden v. Garafalo*, 687 F.2d 1139 (2d Cir. 1982).

Franchising and distributorship agreements have been held to be securities in some cases. See, e.g., *United States v. Herr*, 338 F.2d 607 (7th Cir. 1964); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973). They have been held not to be securities in others. See, e.g., *Chapman v. Rudd Paint and Varnish Co.*, 409 F.2d 635 (9th Cir. 1969); *Martin v. T. V. Tempo, Inc.*, 628 F.2d 887 (5th Cir. 1980). The distinction apparently turns on the degree of active participation by the purchaser, and on whether the court perceives the existence of a pyramid sales fraud.

Other areas in which there are decisions of varying tenor involve the sale of some form of personal property accompanied by a servicing or management arrangement, the sale of real estate lots or apartment units, and the sale of memberships in recreational facilities. Decisions by this Court were required to reduce or end conflicts over the status of employee pension plans, *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979), bank certificates of deposit, *Marine Bank v. Weaver*, ... U.S. ....., 102 S.Ct. 1220 (1982), and cooperative apartments, *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). The field is surveyed in all its contradictory complexity in C. Schneider, "The Elusive Definition of a 'Security' ", 14 *Rev. Sec. Reg.* 981 (1981).

The results in these cases can be understood and reconciled in some, though not all, instances, but the rationales by which they are justified have become numerous and inconsistent, leaving their extension to new situations in considerable doubt. Lower courts have sometimes endeavored to found their decisions on a mere linguistic parsing of the *Howey* formula, and the whole exercise has taken on an increasingly arbitrary and confusing cast.

3. A clarification by this Court is practicable, and this case is an appropriate vehicle for articulating an approach possessing greater coherence and affording greater guidance.

A return to statutory fundamentals is overdue. The Securities Act of 1933 was intended to improve the functioning of the public capital markets; it adopted two strategies to that end. The registration sections of the Act (§§ 5-8, 10, 11 and 12(1)), which are in issue here, created an elaborate (and expensive) disclosure system for the sale of securities to the public by the firm and its controlling insiders. The anti-fraud sections (§§ 12(2) and 17) established a federal standard, broader than typical state common law misrepresentation and deceit actions, for securities sales generally.

By enacting the registration provisions of the 1933 Act, Congress made the judgment that the value of the information required to be disclosed to the public investing in new securities issued by business firms would typically justify the substantial compliance costs entailed. But as the application of the Act shifts from the public capital market for corporate stocks and bonds to more unusual situations and instruments, the courts are necessarily being asked to decide whether the premises of that judgment remain valid in the marginal cases.

To make such a decision intelligently, a court must be sensitive to the factors that bear on the value of the information generated by the registration statement machinery and on the burden of compliance. More than a mechanical recitation of the *Howey* formula is required for such an analysis. Nor is a simple presumption of broad coverage an adequate substitute; that assumes that disclosure requirements are costless or that Congress made an *un*limited judgment as to their suitability. Neither assumption is true.

In short, in cases outside "the ordinary concept of a security",[2] the definition turns on an assessment of the value of disclosure and the cost burden entailed, in the context of the particular investment involved. The form of the instrument by itself cannot be determinative, as this Court has held.[3]

In making that assessment, modern finance theory can be quite helpful. Capital investments within the purview of the 1933 Act are those made in order to obtain a future (usually monetary) return, as distinguished from consumption investments which are made to obtain and consume a stream of services or satisfactions. This basic distinction was underscored by *United Housing Foundation, Inc. v. Forman, supra,* and *Grenader v. Spitz,* 537 F.2d 612 (2d Cir. 1976).

The expected return from an investment, finance theory holds, is directly proportionate to the expected risk. See,

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[2]H.R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933); quoted in *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837, 851 (1975).

[3]*Ibid.*

e.g., W. Sharpe, *Investments* ch. 6 (2d ed. 1981). Risk can be broken down into constituent elements, such as business risk (arising from factors like the variability of demand, production uncertainties, the course of the economy and the performance of management) and financial risk (arising from the debt/equity leverage of the firm). Information and disclosure are of value only as they contribute to a more accurate estimation of the risk and return. Thus the degree of risk of an investment is a necessary ingredient in determining whether it should be subject to the registration disclosure system of the 1933 Act. If an investment is riskless, or of very low risk, the information contained in a registration statement and prospectus might be extensive and detailed, but on average its value would not warrant the costs of furnishing it. That perception is reflected in the exemption sections of the 1933 Act, which exclude from the disclosure machinery investments such as government obligations[4] and commercial paper.[5] It is also reflected in the recent decision of this court that a bank certificate of deposit, because of government regulation and even more importantly because of federal deposit insurance, is not to be considered a security. *Marine Bank v. Weaver, supra;* see also *International Brotherhood of Teamsters v. Daniel, supra.*

Further, when control over the use of the capital assets being invested in is directly transferred to the purchaser, the probable value of registration statement disclosure is at least reduced. The element of management disclosure is eliminated, and the purchaser may be generally presumed to be better informed than the usual investor about

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[4] § 3(a)(2), 15 U.S.C. § 77c(a)(2).

[5] § 3(a)(3), 15 U.S.C. § 77c(a)(3).

the business risks and returns to be expected, so that the added value of the information in a registration statement is probably low. Cf. *Canfield v. Rapp & Sons, Inc.*, 654 F.2d 459 (7th Cir. 1981).

There are a number of other considerations that bear on a determination of the value of registration statement disclosure, but this petition is not the place for an extended discussion. Turning briefly to the cost side, the relevant factors involve such matters as the homogeneity of the business, the size of the investment, the number of purchasers or transactions to be anticipated, and the availability of alternative sources of information. The relative cost of subjecting to 1933 Act registration a single, directly negotiated, small transaction, for example, is quite high. That perception is reflected in the small offering and private placement exemptions of the Act[6] and in this Court's decision on the guarantee agreement aspect of *Marine Bank v. Weaver, supra.*

This has not been an exhaustive delineation of a more coherent approach to the recurrent problem of defining a security. But this sketch is intended to show that such a treatment of the question is both achievable and important.

4. To summarize in conclusion, a "security" for purposes of the Securities Act of 1933 is not a real world object; it is, in the marginal cases, a judgment that the premises of the Act still hold and the value of the required disclosure would warrant its costs. That judgment depends on the interplay of a number of factors, which the *Howey* formula reflects but does not fully express.

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[6] §§ 3(b) and 4(2), 15 U.S.C. §§ 77c(b) and d(2).

Petitioner submits that the decision of the court below conflicts with the decisions of the Fifth Circuit and of this Court, and will lead to inappropriate determinations of the applicability of the federal securities laws. Petitioner also urges that a re-examination and clarification of the security definition, in the light of modern finance theory, is both timely and feasible.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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(Appendices Follow)